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Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

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BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

This brief is submitted with the written consent of counsel to both parties filed with the Clerk of the Court.

INTEREST OF THE AMICI CURIAE

The American Council of Life Insurance ("ACLI") is a trade association with 646 life insurance company members. These member companies account for 93 percent of all the life insurance business in force in the United States in legal reserve life insurance companies and hold 93 percent of the total assets of all United States life insurance companies. The National Association of Life Companies ("NALC") is a trade association with over

600 small and medium-sized life insurance company members, many of which are also members of the ACLI.

The issue considered by the United States Court of Appeals for the Fifth Circuit in this case involves the Federal income tax treatment of indemnity reinsurance transactions. Specifically, the issue is whether a life insurance company is entitled to deduct currently, in computing its taxable income, the ceding commissions it incurs in issuing indemnity reinsurance to another life insurance company.

As is explained in the argument, *infra*, member companies of the ACLI and the NALC frequently engage in indemnity reinsurance transactions, both as reinsurers and as ceding companies. The treatment of ceding commissions affects not only the tax liability of the companies issuing indemnity reinsurance, but also the cost to companies obtaining the indemnity reinsurance coverage. Thus, the issue in this case is of major importance to the members of the ACLI and the NALC.

SUMMARY OF ARGUMENT

For many years, life insurance companies have currently deducted the ceding commissions they incur in issuing indemnity reinsurance contracts. The Commissioner of Internal Revenue now contends that such ceding commissions are not currently deductible. The lower courts disagree on the issue.

Indemnity reinsurance is of major importance to the life insurance industry because life insurance companies regularly use indemnity reinsurance to ensure adequate distribution of risk, as well as to reduce surplus strain caused by issuing new coverage. The importance of indemnity reinsurance is demonstrated by the large amounts issued. The uncertainty as to the Federal income tax treatment of indemnity reinsurance ceding commissions should be resolved.

ARGUMENT

I. The Commissioner's Position that Reinsurers Cannot Deduct Indemnity Reinsurance Ceding Commissions and the Conflicting Decisions of the Lower Courts Have Created Uncertainty About the Federal Income Tax Treatment of Indemnity Reinsurance

In the 30 years since Congress enacted the Life Insurance Company Income Tax of 1959, Pub. L. No. 86-59, 73 Stat. 112 [hereinafter the 1959 Act], life insurance companies consistently have deducted the ceding commissions they incur in issuing indemnity reinsurance contracts. This treatment, which is identical to the treatment that has been required since 1951 by the National Association of Insurance Commissioners for state accounting purposes, was not publicly challenged by the Commissioner of Internal Revenue until 1982. *See* Rev. Rul. 82-69, 1982-1 C.B. 102. In that ruling, the Commissioner for the first time publicly contended that indemnity reinsurers must capitalize, rather than deduct, ceding commissions paid in an indemnity reinsurance transaction. *Id.*[1]

The United States Tax Court has consistently rejected the Commissioner's position and has held that ceding commissions paid in an indemnity reinsurance transaction are currently deductible. *See Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627 (1982); *Merit Life Ins. Co. v. Commissioner*, T.C. Memo 1986-480 [1986 P-H Memo T.C. 86-2188], *aff'd*, 853 F.2d 1435 (7th Cir. 1988); *Colonial Am. Life Ins. Co. v. Commissioner*, T.C. Memo 1986-226 [1986 P-H Memo T.C. 86-938], *rev'd*, 843 F.2d 201 (5th Cir. 1988); *Individual Life Assurance Co. v.*

[1] Prior to Rev. Rul. 82-69, the Commissioner had issued technical advice memoranda contending that indemnity reinsurance ceding commissions had to be capitalized. *See* PLR 7844002 (July 13, 1978); PLR 8205015 (Oct. 29, 1981). These technical advice memoranda do not constitute precedent and may not be used as such. *See* I.R.C. § 6110(j)(3).

Commissioner, T.C. Memo 1986-201 [1986 P-H Memo T.C. 86-339], *revised per non precedential memorandum sur order* (Oct. 8, 1987). The United States Court of Appeals for the Seventh Circuit has also rejected the Commissioner's position. *Merit Life Ins. Co. v. Commissioner*, 853 F.2d 1435 (7th Cir. 1988).

On the other hand, the United States Court of Appeals for the Eighth Circuit has agreed with the Commissioner that indemnity reinsurance ceding commissions should be capitalized, *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987), as has the United States Court of Appeals for the Fifth Circuit in the instant case. *Colonial Am. Life, supra. See also Modern Am. Life Ins. Co. v. Commissioner*, 818 F.2d 1386 (8th Cir. 1987), *rev'g Modern Security Life Ins. Co. v. Commissioner*, T.C. Memo 1985-629 [1985 P-H Memo T.C. 85-2799].[2]

The Commissioner's position, and the decisions of the Fifth and Eighth Circuits, have called into question the tax treatment of a fundamental part of an indemnity reinsurance transaction. Although each of the cases cited involves the treatment of indemnity reinsurance ceding commissions under the 1959 Act, the holdings of the decided cases are equally applicable under current law.[3] This uncertainty directly affects reinsurers which have for thirty years deducted ceding commissions paid to ced-

[2] The issue is also pending in the United States Court of Appeals for the Ninth Circuit on appeal from a United States District Court decision for the Commissioner. *Oxford Life Ins. Co. v. United States*, No. 88-2955 (9th Cir.), *on appeal from* No. CIV-84-959-PHX-RGS, slip op. (D. Ariz. Oct. 15, 1987).

[3] In the Deficit Reduction Act of 1984, Congress repealed the 1959 Act and enacted a new regime for taxing life insurance companies. P.L. 98-369, 98 Stat. 484, §§ 201-219 [hereinafter the 1984 Act]. However, the 1984 Act did not substantively alter the Internal Revenue Code provisions applicable to the treatment of indemnity reinsurance ceding commissions. *Compare* §§ 809(c)(1) and 809(d)(12) as in effect (during 1975 and 1976) under the 1959 Act *with* §§ 803(a)(1) and 805(b)(8) as in effect under the 1984 Act.

ing companies. In addition, the uncertainty indirectly affects all insurance companies which purchase indemnity reinsurance coverage because the price of such coverage naturally will reflect the tax treatment of ceding commissions paid by those companies which issue it.

II. The Federal Income Tax Treatment of Indemnity Reinsurance is of Major Importance to the Life Insurance Industry

There are two general types of reinsurance: indemnity reinsurance and assumption reinsurance. *See generally*, Steffen, Reinsurance, in LIFE and HEALTH INSURANCE HANDBOOK (D. Gregg and V. Lucas eds. 1973). Assumption reinsurance occurs relatively infrequently and typically is used to dispose of all of a life insurance company's business or a particular line of its business. *Id.*, at 1003-1004.

In contrast, indemnity reinsurance occurs regularly in the life insurance industry. Indemnity reinsurance is an insurance agreement by means of which a life insurance company, often termed a "ceding company," transfers all or a portion of its risk under a life insurance policy to another company, often termed a "reinsurer." *Id.*, at 991. The nature of indemnity reinsurance was summarized by the United States Court of Appeals for the Seventh Circuit in *Merit Life, supra*:

> In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policyholders. No relationship, contractual or otherwise, exists between the reinsurer and the policyholders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange,

> the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission.

853 F.2d at 1436.

Indemnity reinsurance serves a wide variety of purposes, one of the most important of which is the spreading of risk.[4] The spreading of risk, known as risk distribution, is an essential element of insurance because it avoids the concentration of too much risk in one insurance company. *See* K. Black & H. Skipper, Jr., *supra* note 4, at 431; *see also Helvering v. LeGierse*, 312 U.S. 531 (1941).

The need to distribute risk, however, limits the amount of risk that an insurance company can safely assume by itself with respect to any one insured. *See generally* K. Black & H. Skipper, Jr., *supra* note 4, at 431. Every life insurance company thus establishes a limit on the maximum amount of life insurance protection that it will carry on any one individual. *See* Steffan, *supra*, at 992. These limits, known as "retention" limits, vary considerably in size, from $5,000 to over $1,000,000, but all companies have them.[5] A.M. Best Co., BEST'S AGGREGATES & AVERAGES LIFE-HEALTH (7th ed. 1988) 48 [hereinafter BEST'S AGGREGATES and AVERAGES].

While retention limits are necessary to avoid excessive concentration of risk, those limits standing alone might

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[4] Indemnity reinsurance is also used to reduce the drain on surplus caused by writing new business, thereby allowing small and growing life insurance companies to continue issuing insurance, and to stabilize the mortality experience of the ceding company. *See* K. Black & H. Skipper, Jr., LIFE INSURANCE 431 (11th ed. 1987).

[5] A number of considerations are involved in determining a life insurance company's retention limit, including the amount of the insurer's surplus, expected mortality, the nature of the policies and their distribution among age groups, and the cost of obtaining indemnity reinsurance. Steffan, *supra*, at 992-93.

prevent a life insurance company from issuing a life insurance policy for the amount of life insurance protection a prospective insured needs. It is indemnity reinsurance which makes it possible for a life insurance company to issue the desired amount of insurance while protecting itself against loss in excess of its retention limit. *See* Steffan, *supra*, at 991-92. For example, a small life insurance company which has determined that it cannot safely carry a risk of more than $10,000 per insured may receive an application from an individual who desires coverage of $25,000. Through indemnity reinsurance, the company can nevertheless issue the $25,000 policy, retaining $10,000 of risk and ceding the remaining risk to an indemnity reinsurer. Indemnity reinsurance thus allows insurance companies to achieve the degree of risk spreading necessary to make insurance work.

The importance of reinsurance to the life insurance industry is evidenced by its volume. At the end of 1987, the life insurance industry had $8.87 trillion of life insurance in force. BEST'S AGGREGATES and AVERAGES, at 50. Of that amount, $1.78 trillion was reinsured. *Id.* at 49. Furthermore, in 1987, the life insurance industry issued $1.52 trillion of new life insurance coverage, and $.44 trillion of coverage was reinsured. *Id.*, at 49-50. A precise indentification of the proportion of this reinsurance which is indemnity reinurance is not possible, but given the frequency and purposes of indemnity reinsurance it is believed that the preponderance of this reinsurance is indemnity reinsurance.

In summary, indemnity reinsurance is necessary to the daily operations of the life insurance business, enabling life insurance companies to effect adequate distribution of risk and to reduce surplus strain. In addition, indemnity reinsurance is issued in substantial amounts. Thus, the Federal income tax treatment of indemnity reinsurance is of major importance to the life insurance industry, and the uncertainty created by the Commis-

sioner's position and the conflicting judicial decisions should be resolved.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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